

January 11, 1999

Mr. Bob Hood
Acting Chief, Audits Branch
Accounting Safeguards Division
Common Carrier Bureau
Federal Communications Commission
2000 L Street, NW, Room 257
Washington, DC 20036

RE: Audit Report of the Continuing Property Records of Ameritech

Dear Mr. Hood:

Ameritech submits the attached comments on the draft copy of the final audit report of Ameritech's Continuing Property Records (CPR) provided to Ameritech on December 23, 1998 (See Common Carrier Bureau, Accounting Safeguards Division, Audit of the Continuing Property Records of Ameritech, DRAFT (the "December Report")).

As Ameritech's comments demonstrate, the December Report's conclusions are flawed and the recommendations have no basis. Specifically, Ameritech has not violated the Commission's continuing property record (CPR) rules. The recommendation to write-off \$306.0 million of hardwired Central Office Equipment (COE) investment is based on deficient audit procedures and seriously flawed statistical analyses. The recommendation to write-off an additional \$260.7 million of Undetailed Investment that continues to be used and useful is incorrect. Even if the proposed recommendations to write-off this investment were valid, there has been absolutely no adverse impact on Ameritech's customers that would justify any reduction of Ameritech's current rates.

Although Ameritech disagrees with the unwarranted and unnecessary recommendation that it engage an independent firm to inventory its entire COE, since Ameritech is fully confident that its practices, procedures, and controls for maintaining CPR are compliant with the Commission's rules in all material respects, it is willing to discuss the engagement of an independent auditor to review such practices, procedures, and controls. Ameritech would further agree, if shown to be necessary as a result of any independent review, to develop and submit to the Commission for approval, a plan of corrective action based on the independent audit. Clearly any write-off of investment prior to a review of Ameritech's practices, procedures, and controls is premature and inappropriate.

Notably, as the December Report states, Ameritech's CPR was the subject of an audit in 1994. The preliminary conclusion of that audit report - in stark contrast to the Accounting Safeguards Division's flawed current report - was that there was no evidence to lead the auditors to a conclusion that Ameritech was not in compliance with the Commission's CPR rules. That finding alone seriously calls into question any current Accounting Safeguards Division conclusions related to the CPR.

Previously, Ameritech submitted a response on August 26, 1998 to the Accounting Safeguards Division to the draft audit report of July 27, 1998 (the "July Report"). Ameritech's August 26, 1998 response also included an independent and objective review of the audit process and results by Arthur Andersen LLP (AA). Since only minor adjustments were made in the December Report, Ameritech's current response reflects the same comments, assessment, and conclusions reached by Ameritech's and AA's review previously provided in Ameritech's August 26, 1998 response (See Affidavit of Mr. Carl R. Geppert of AA at Appendix A-0). Namely, the findings contained in the December Report are fatally deficient with respect to audit procedures pursuant to generally accepted auditing standards (GAAS), statistical methodology, and the scoring of audited results. As a result, the December Report cannot be relied on to reach any conclusions on the fair presentation of Ameritech's investment balances.

Ameritech strongly objects to the inclusion in the December Report of an alleged overstatement of a category of investment entitled Undetailed Investment. Undetailed Investment is a term in use for over thirty years and represents used and useful investment that preceded the introduction of the mechanized Plug-In Inventory Control/Detailed Continuing Property Record (PICS/DCPR) system. The December Report's alleged overstatement also mistakenly includes \$109 million of investment related to the purchase of telecommunications plant with traffic from Sprint that was detailed by year end, 1998. Excluding the Sprint investment, Ameritech has reduced Undetailed Investment from \$555 million as of December 31, 1993 to \$138.8 million as of August 31, 1998, or a 75 percent reduction in less than five years. This reduction demonstrates that as the equipment is taken out of service, it is retired. Ameritech has plans to retire the remaining investment when appropriate.

Ameritech also strongly objects to the characterization of its alleged CPR problems as "longstanding" and "deeply ingrained" relying on the audit of Ameritech conducted by the Accounting Safeguards Division in 1994. As noted above, contrary to the December Report, the preliminary conclusion of the 1994 audit was that nothing led the auditors to conclude that Ameritech was not in compliance with the Commission's CPR rules. This conclusion is hardly an indication of a "longstanding" and "deeply ingrained" problem.

Furthermore, Ameritech demonstrates in its attached comments, that there has been no adverse impact on ratepayers. The CPR requirements have no impact on ratemaking since Ameritech has been under price cap regulation since 1991. Moreover, the audit has not established that there were any actual overstatements of plant central office equipment (COE) investment. Any CPR discrepancies were most likely immaterial record-keeping matters and may at most reflect delayed retirements.

Given the conclusions reached by Ameritech and AA in their reviews, Ameritech submits that the December Report is flawed. Even so, Ameritech's understanding is that a final audit report, together with Ameritech's response, is planned for public release by the Commission. Should a final audit report be released, Ameritech submits that it would be inappropriate to rely on the report for purposes of any future contemplated action because there is no adverse ratepayer impact under price cap regulation.

Please contact either me or Ms. Robin Gleason (847/248-3398) if you need to discuss this matter further.

Sincerely,

Anthony Alessi

cc: Mr. Kenneth Moran
Mr. Lawrence Strickling
Mr. Yog Varma

Attachments
Diskette

Comments of Ameritech
on
December 22, 1998 Draft Audit Report
of Ameritech's Continuing Property Record (CPR)
January 11, 1999

Following are Ameritech's comments on the December 22, 1998 Draft Audit Report. The comments are organized as follows:

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for
Ameritech's Comments on the
December 22, 1998 Draft Audit Report
of Ameritech's Continuing Property Record (CPR)
January 11, 1999

Following are files that are on Ameritech's submitted diskette. All files were saved using Microsoft® Word version 97 SR-1.

<u>FILENAME</u>	<u>CONTENTS OF FILE</u>
Response.doc	Cover Letter Executive Summary Analysis and Discussion Conclusion
App-a-0.doc	Appendix A-0: Evaluation of December 22, 1998 Draft Report
App-a-1.doc	Appendix A-1: Executive Summary
App-a-2.doc	Appendix A-2: Background
App-a-3.doc	Appendix A-3: Affidavit of Carl R. Geppert on the Adequacy of the Audit Procedures Conducted by the Accounting Safeguards Division
At-a-3-1.doc	Appendix A-3: Attachment 1
App-a-4.doc	Appendix A-4: Affidavit of Carl R. Geppert on Scored Results
At-a-4-1.doc	Appendix A-4: Attachment 1
At-a-4-2.doc	Appendix A-4: Attachment 2
At-a-4-3.doc	Appendix A-4: Attachment 3
App-a-5.doc	Appendix A-5: Affidavit of Paul F. Charnetzki on Statistical Methodology used by the Accounting Safeguards Division plus Attachments
At-a-5-1.doc	Appendix A-5: Attachment 1
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App-b.doc	Appendix B: Ameritech Re-scoring of Inconsistent Scored Results of Accounting Safeguards Division
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App-d.doc	Appendix D: Affidavit of Larry C. Maggiefeld, Ameritech Engineer on Undetailed Investment
App-g.doc	Appendix G: Affidavit on Detailing \$114 M of Undetailed Investment

I. Executive Summary

The following comments address the conclusions and recommendations in the draft copy of the final audit report of Ameritech's Continuing Property Records (CPR) provided to Ameritech on December 23, 1998 (See Common Carrier Bureau, Accounting Safeguards Division, Audit of the Continuing Property Records of Ameritech DRAFT, (the "December Report")).

Previously, Ameritech submitted a response on August 26, 1998 to Accounting Safeguards Division's draft audit report of July 27, 1998 (the "July Report"). Ameritech's response included the independent review of Arthur Andersen LLP (AA), engaged by Ameritech to evaluate the adequacy and completeness of the audit procedures, conduct a limited reperformance of the physical verification procedures, review supplemental information, and evaluate the statistical procedures used by the Accounting Safeguards Division. Since only minor adjustments were made to the December Report, Ameritech's current response reflects the same comments, assessment, and conclusions reached by Ameritech's and AA's review previously provided on August 26, 1998 to the July Report (See Affidavit of Carl R. Geppert at Appendix A-0). Namely, the conclusions contained in the December Report are fatally deficient with respect to audit procedures pursuant to generally accepted auditing standards (GAAS), statistical methodology, and the scoring of audited results.

The December Report is the result of a November, 1997 physical verification of certain hardwired central office equipment (COE) conducted by the Accounting Safeguards Division in 34 central offices using a July 31, 1997 data base and a total of 1,224 sampled items. Each sampled item was coded in one of four ways:

- (1) Item(s) in sufficient quantity in the CPR-stated location.
- (2) Item(s) matching the CPR description found in another location within the office.
- (3) Item(s) not found or not found in sufficient quantity.
- (4) Item(s) could not be verified as either found or not found for various reasons.

The December Report concludes that Ameritech's COE plant investment is overstated by \$306.0 million of hardwired central office equipment (COE) investment. The December Report also includes as overstated \$260.7 million of an investment category entitled Undetailed Investment. In addition, the December Report found that 23.3 percent of Ameritech's records are substantively deficient and do not comply with the Commission's rules (those items scored a 2, 3, and 4).

The December Report recommends that Ameritech (i) write-off the \$566.7 million of COE plant investment (\$306.0 million of hardwire COE plus \$260.7 million of Undetailed Investment), (ii) engage an independent firm to inventory its entire COE and provide the results to the Commission, (iii) make necessary accounting entries as a result of the inventory, (iv) engage an independent auditor to review its CPR practices, procedures, and controls and make recommendations for improvements and, (v) develop and submit to the Commission for approval a plan of corrective action.

Ameritech disagrees with the conclusions and recommendations in the December Report. Ameritech's CPR is not deficient in any material respect with the Commission's CPR rules and there is no violation of the Commission's Part 32 rules related to CPR requirements. Ameritech submits that its methods, procedures, systems, processes, and internal controls produce reliable results and its plant balances are accurately stated. The Accounting Safeguards Division conducted one-day physical inventories in 34 of Ameritech's central offices. Internal controls and processes related to Ameritech's maintenance of the CPR were not tested. The results of this physical inventory audit cannot result in an opinion on the fair presentation of Ameritech's hardwired COE plant investment. Neither do the audit results accurately reflect how customers or shareholders are affected by these record-keeping requirements. There has

been absolutely no adverse impact on Ameritech's customers that would justify any reduction of Ameritech's current rates.

Specifically, Ameritech disagrees with the conclusions and recommendations of the December Report for the following reasons (See also, Affidavit of Carl R. Geppert at Appendix A-0):

- (1) The audit procedures used by the Accounting Safeguards Division were inadequate under generally accepted auditing standards ("GAAS") to form an opinion on the fair presentation of Ameritech's hardwired COE plant investment. The Accounting Safeguards Division conducted a physical inventory, but did not test internal controls, general ledger balances, or collect other corroborating audit information which would be required in order to opine on the fair presentation of Ameritech's COE hardwire investment. Additionally, the Accounting Safeguards Division did not apply alternative procedures such as follow-up site visits as required by GAAS.
- (2) No standards were ever discussed or communicated to Ameritech related to the adequacy of supplemental information or documentation provided to the Accounting Safeguards Division by Ameritech subsequent to the physical inventory. It appears that the Accounting Safeguards Division did not rely on the significant supplemental information provided by Ameritech. The scoring criteria used by the Accounting Safeguards Division remain unexplained and has resulted in inconsistent scoring of items where virtually identical documentation was provided.
- (3) AA has substantiated the existence of certain COE items previously scored "3", not found, by the Accounting Safeguards Division through physical verification or review of supplemental information.
- (4) AA has determined that the statistical methodology used by the Accounting Safeguards Division with respect to both sample design and extrapolation is flawed, inaccurate, and unreliable. Further efforts to corroborate the statistical methodology using the Bayesian methodology are unavailing. While the exact procedures used in this analysis were not provided in the December Report, it is unlikely that the inclusion of the Bayesian methodology corrects for identified errors in statistical design, implementation, technique, or logic.
- (5) Ameritech strongly objects to the inclusion in the December Report of an alleged overstatement of a category of investment entitled Undetailed Investment. Undetailed Investment is a term in use for over thirty years and is used and useful analog investment that preceded the introduction of the mechanized Plug-In Inventory Control/Detailed Continuing Property Record (PICS/DCPR) system. The December Report's alleged overstatement also mistakenly includes \$109 M of investment related to the purchase of telecommunications plant with traffic from Sprint that was detailed by year end, 1998. Ameritech has reduced Undetailed Investment from \$555 M as of December 31, 1993 to \$138.8 M as of August 31, 1998, or a 75 percent reduction in less than five years (See Appendix G). This reduction demonstrates that as the equipment is taken out of service, it is retired. Ameritech has plans to retire the remaining investment when appropriate.
- (6) The December Report has included items scored a "2", i.e. items matching the CPR description found in another location within the central office, as part of the 23.3 percent of records alleged to be seriously deficient. Ameritech disagrees with this narrow and unrealistic interpretation and requests that items scored a "2" be combined with those items scored a "1", i.e. item found. There is nothing in the Commission's rules or common language usage that justifies classifying an item FOUND as UNVERIFIABLE. At a minimum, those items scored a "2" should be separately identified on the December Report so users are not misled with the narrow interpretation applied by the Accounting Safeguards Division.
- (7) Ameritech disagrees that CPRs have any impact on customer rates. The current CPR requirements were adopted under a cost of service/rate of return regulatory paradigm that the Commission

changed in 1991 with the adoption of price caps. Under price caps, the linkage between costs and customer rates no longer applies. Also, cost studies for services, such as unbundled network elements, are based on forward-looking models and do not rely on accounting data. Therefore, even if the proposed recommendation to write-off investment were valid, there has been absolutely no adverse impact on Ameritech's customers that would justify any reduction of Ameritech's current rates.

- (8) Ameritech strongly objects to the characterization of its alleged CPR problems as "longstanding" and "deeply ingrained" relying on the audit of Ameritech conducted by the Accounting Safeguards Division in 1994. Contrary to the December Report, the preliminary conclusion of the 1994 audit was that nothing led the auditors to conclude that Ameritech was not in compliance with the Commission's CPR rules. This conclusion is hardly an indication of a "longstanding" and "deeply ingrained" problem.
- (9) It is simply premature to write-off investment given the deficiencies identified by both Ameritech and AA in the December Report and prior to any discussions related to the possible engagement of an independent review of Ameritech's procedures, practices, and controls related to CPR.

With respect to the December Report's recommendations, Ameritech cannot agree to a write-off of the \$306.0 million of hardwired COE. The identified deficiencies in the audit procedures and statistical methodology render the results of the physical verification audit conducted by the Accounting Safeguards Division unreliable. Moreover, a write-off of \$306.0 million is contrary to the Commission's rules requiring a retirement entry to be referenced to the CPR from which the cost was obtained (See C.F.R. 32.2000(d)(1)). In other words, a write-off makes no practical accounting sense in that the particular plant and location for which the plant is to be written off are not identified since the alleged overstatement is based on an invalid extrapolation. Since the alleged overstatement is an extrapolated amount, there is no such reference to the CPR (See also, Affidavit of Carl R. Geppert at Appendix A-0 at 8-9). Further, Ameritech cannot agree to a write-off of \$260.7 million of Undetailed Investment because \$109 million represents COE purchased from Sprint that was detailed by end of year, 1998 and the balance represents used and useful telecommunications equipment.

Ameritech also cannot agree to engage an independent firm to inventory its entire COE. Such an audit is not justified because Ameritech maintains this investment is used and useful in the provision of telecommunications and the physical audit conducted by the Accounting Safeguards Division has not shown otherwise. Furthermore, an inventory does not withstand a cost benefit consideration. It is estimated that an inventory of its entire COE could take over five years at 700,000 hours and cost over \$35 million. Apart from any cost benefit considerations, such an undertaking is unwarranted and premature prior to any assessment of Ameritech's CPR practices, procedures, and controls.

Although Ameritech disagrees with the recommendations to write-off investment or engage an independent firm to inventory its entire COE, since Ameritech is fully confident that its practices, procedures, and controls for maintaining CPR are compliant with the Commission's rules in all material respects, Ameritech is willing to discuss the engagement of an independent auditor to review its CPR practices, procedures, and controls and make recommendations for improvements, if necessary. Ameritech would further agree to develop and submit to the Commission for approval a plan of corrective action based on any agreed upon independent review, if such corrective action is found to be necessary.

It is Ameritech's understanding that a final audit report, together with Ameritech's response, is planned for public release. As a result of deficiencies identified by both AA and Ameritech however, Ameritech submits that the December Report should not be relied on by the Commission with respect to any future contemplated action. Additionally, the Commission should streamline the CPR requirements now and implement a transition plan for their eventual elimination.

II. Analysis and Discussion

A. The Audit Process and Results

1. The Audit Process

The conclusion in the December Report that Ameritech has overstated its COE hardwire investment is incorrect (See December Report at 3). Ameritech's methods and procedures, systems, processes and internal controls produce reliable results and its plant balances are accurately stated. Rather than fully auditing these internal controls and processes and examining the ledger balances, the Accounting Safeguards Division conducted one-day physical inventories in 34 of Ameritech's central offices. The results of this physical inventory audit do not fairly reflect how customers or shareholders are affected by these record-keeping requirements.

Further, the Accounting Safeguards Division's interpretation of the rules would say that the item must be found in a specific bay-shelf-position. Items found within the central offices but in a different bay or floor were considered "unverifiable" by the Accounting Safeguards Division (See December Report at 3 and Appendix C). This categorization defies the plain meaning of common ordinary language and results in unrealistic and misleading scoring for items found within a central office in a different bay or floor. These items should be considered found and should not be included in the records the Accounting Safeguards Division considers substantively deficient.

Ameritech retained the services of Arthur Andersen LLP (AA) to review the audit procedures employed by the Accounting Safeguards Division. AA concluded that the procedures used by the Accounting Safeguards Division were inadequate under generally accepted auditing standards ("GAAS") in order to form an opinion on the fair presentation of Ameritech's hardwired central office equipment (COE) plant investment (See Affidavit of Carl R. Geppert at Appendix A-0 at 2-3; See also, Arthur Andersen Report at Appendix A-1 and Appendix A-3, Affidavit of Carl R. Geppert). A physical verification audit, as was conducted by the Accounting Safeguards Division, requires other corroborating evidence in order to form an opinion on the fair presentation of the investment. Such corroborating evidence would include sufficient testing of internal control procedures (See Affidavit of Carl R. Geppert at Appendix A-0 at 3-4; See Arthur Andersen Report at Appendix A-1 and Appendix A-3, Affidavit of Carl R. Geppert).

Ameritech submits that no such testing of internal control procedures was undertaken by the Accounting Safeguards Division. Additionally, the audit was deficient in that (i) there was a four month time lapse between the physical verification conducted by the Accounting Safeguards Division and the listing of the CPRs on which the sampled items were selected and physically verified with no procedures to reflect any retirements or adjustments during this four month period, (ii) the audit procedures would only uncover overstatements of plant investment; there was no audit consideration given to uncover plant understatements, (iii) there was a limited amount of time to locate the sampled items and, (iv) Ameritech's COE account general ledger balances were not reviewed (See Affidavit of Carl R. Geppert at Appendix A-0 at 3-4; See Arthur Andersen Report at Appendix A-3, Affidavit of Carl R. Geppert).

If anything, this audit highlights that the CPR requirements are unrealistic for a going-concern business which, on a daily basis, is responding to customer service requests, repair and maintenance requirements, plant upgrades and modernization and other customer service activities. The Commission's rules require detail that is above and beyond what management needs to run the business. As made evident in a recent AA paper, the CPR requirements are in dire need of an overhaul to reflect regulatory policy objectives and evolving business needs (See Accounting Simplification in the Telecommunications Industry, Prepared by Arthur Andersen LLP, July 15, 1998, "Arthur Andersen Simplification Proposal" at Sections I and V; See also Supplement to July 15, 1998 Position Paper, Prepared by Arthur Andersen LLP, November 10, 1998).

It will be helpful to review the details of the inventory audit conducted by the Accounting Safeguards Division in order to put this audit in perspective. In doing so, it is important to understand the complexity of a typical Ameritech central office.

Ameritech has about 1,500 central offices in its region. The average Ameritech central office has 50 thousand pieces of equipment. In total, Ameritech has 62 million pieces of central office equipment. Most central offices have multiple floors of equipment. Each central office can have generations of equipment that span more than 50 years. For example, a typical office can have equipment from 1941 to 1998. There could be several generations of certain types of equipment, such as power equipment, in each office.

In terms of the physical inventory process, the Accounting Safeguards Division selected 34 Ameritech central offices and a sample of 36 items within each office for physical verification. Four to five workdays prior to the field visits, Ameritech was given the list of 34 central offices and coordinated the logistics (i.e. assigning engineers to offices). Ameritech did not receive the 36 items per office (versus an average of 50 thousand items per office), which would be subject to the physical verification process until the morning of the field visit. Also, the sample was taken from a database reflecting records as of July 31, 1997, while the field visits occurred in November 1997.

In brief, it appears that the Accounting Safeguards Division chose to narrowly and unrealistically interpret its rules to require that Ameritech physically verify the 36 items (out of an average of 50 thousand items) in each office in one day. There are probably no instances in normal business of such an elaborate record-keeping requirement such that auditors could physically verify 1 thousand items out of approximately 1 million 7 hundred thousand items in 34 different locations in one day, let alone one or two months later. It is also unrealistic that most normal businesses could produce supporting documentation, such as the original invoices, for each of these 1000 items, some purchased in the 1950s and 1960s.

Although the Accounting Safeguards Division allowed Ameritech to provide supporting documentation for about two months after the physical verification, the documentation was apparently not fully taken into account in the December Report. The Accounting Safeguards Division changed very few items to a found designation based on the additional supporting documentation.

Ameritech believes that an explanation exists for items that could not be physically verified by the staff of the Accounting Safeguards Division in November 1997. Some items were located shortly after the one-day physical verification by the Accounting Safeguards Division. Any remaining issues that may exist are probably routine clerical errors or record-keeping delays associated with retirements that any going concern business focused on customer needs confronts. Ameritech does not believe however, that the benefits of expending additional resources in a quest to locate each and every item within its specific bay in a central office outweigh the costs associated with such a search. This is especially so given that the continuing property records have no bearing on customer rates, as is discussed more fully in Section IIB.

2. Scoring Criteria of the Accounting Safeguards Division

Fundamental to any discussion of the results is the definition of an error on which the calculated results are based. The audit verification results should reflect the manner in which the sample results were coded. The sample results were coded in one of four ways (See December Report at 21 and Appendix C):

- (1) Item(s) in sufficient quantity in the CPR-stated location.
- (2) Item(s) matching the CPR description found in another location within the office.
- (3) Item(s) not found or not found in sufficient quantity.
- (4) Item(s) could not be verified as either found or not found for various reasons.

Ameritech received preliminary assessments by the Accounting Safeguards Division on their fieldwork for the 36 line items in 34 central offices and was requested to provide a perspective on the findings. Limited information regarding standards for the adequacy of expected documentation were communicated to Ameritech. The Accounting Safeguards Division requested a response by January 23, 1998 (See Correspondence of Ms. Patricia Green to Mr. Anthony Alessi, January 7, 1998). Ameritech undertook an analysis and provided supporting documentation and explanations for each item scored a "3", not found, or "4", other, and requested that most of the items be re-scored to either a "1", found, or "2", found in different location (See Correspondences of Mr. James Deignan to Ms. Patricia Green, of January 23, 1998, February 13, 1998, and February 20, 1998). The aggregate results of the December Report suggests that very few results scored by the Accounting Safeguards Division were changed to reflect Ameritech's supporting documentation and explanation. Ameritech's initial review and substantiation of the Accounting Safeguards Division scoring resulted in a proposed reclassification of items coded "3" and "4" to a score of "1" and "2" for 91 sampled items. While it is common practice for an auditor to accept such evidence to avoid making incorrect inferences, based on the December Report's current results, the Accounting Safeguards Division apparently reclassified very few out of the 91 submitted by Ameritech (Note: Ameritech is making a request for the scoring by central office underlying the December Report in a separate transmittal). The criteria used by the Accounting Safeguards Division remain unexplained.

Ameritech's subsequent review of the aggregate results contained in the December Report suggests that the Accounting Safeguards Division was not consistent in their assessment and application of supplemental information provided by Ameritech. For example, in the July Report, items similar to those re-scored by the Accounting Safeguards Division from a score of "4", other, to "1", found, remain with their initial score of "4". That is, an item was initially scored a "4", other, because the quantity on the CPR showed zero, even though the Accounting Safeguards Division physically verified the item. In some instances, the Accounting Safeguards Division revised the score to "1", found, when Ameritech provided additional information demonstrating the appropriateness of a zero quantity count for an item supplemental to another item on the CPR. In other similar cases, where the same supplemental information was provided, the items were not re-scored by the Accounting Safeguards Division. Appendix B contains a listing of such inconsistencies.

3. Scoring Results of the Accounting Safeguards Division

The December Report concludes that out of a sample of 1,224 line-items (36 central office equipment items in 34 offices), 23.3 percent of the records are alleged to be seriously deficient (items scored a 2, 3, and 4). The 23.3 percent consists of 10.5 percent of items that could not be found (items scored a 3) and 12.8 percent that could not be verified with certainty (items scored a 2 and 4). Based on the items scored a "3", it is estimated that the hard-wired COE plant investment is allegedly overstated by approximately \$306.0 million (December Report at 3).

The services of AA were retained to review documentation and perform additional physical verifications of disputed items in the July Report. Given that the changes made to the December Report were not significant and the Accounting Safeguards Division did not provide item scoring results, the AA affidavits and results are included in Appendix A. As a result, the December Report's scoring and results are highly questionable. Ameritech submits that the 23.3 percent of records alleged to be seriously deficient and use of the 10.5 percent of the records in calculating the alleged dollar overstatement are incorrect and overstated.

Ameritech submits that inclusion of items coded a "2" in records determined as seriously deficient is incorrect. 122 items, or 9.9 percent of the total sampled items, were located by the auditors on the day of the physical verification, but were found at a different bay/shelf within the central office than that specified on the CPR. Classifying these items as unverifiable in the table on Page 9 of the December

Report and referring to these items as seriously deficient defies the plain meaning of common ordinary language. These items should not be considered unverifiable. Rather, these items should be considered found.

Ameritech's interpretation is fully consistent with both the Commission's CPR rules and Ameritech's Basic Property Records (BPR) (See Ameritech Operating Companies' Submission of Procedures for Maintaining Basic Property Records, June 30, 1989). The Commission's CPR rules state that the basic property records shall contain detailed information on, inter alia, specific location (See C.F.R. at 32.2000(e)(1)(i); 32.2000(f)(2)(iii); 32.2000(f)(5)). There is no definition of "specific" location within the Commission's rules however, which suggests that "specific" location means a "specific" bay/shelf within a central office. Rather, property records are to be maintained by accounting area, where accounting area is defined as the "smallest territory of the company." (See C.F.R. at 32.2000(f)(1)(i)). Ameritech's BPR is fully consistent with the Commission's rules with respect to "specific" location. Ameritech's BPR states that the property record units are to be maintained at a "Specific location of the plant within each accounting area..." (emphasis added), where accounting area is defined as the individual operating company, e.g. Illinois Bell Telephone Company (See Ameritech Operating Companies' BPR at pages 4-6; See also GTE's Motion for a Declaratory Ruling On Asset Verification, May 13, 1998 at 6). The physical verification of an item within a "specific" central office within the accounting area meets the Commission's CPR rules. As a result, the 23.3 percent of record items alleged to be deficient is incorrect and overstated.

With respect to the 10.5 percent of items included in any alleged overstatement, this amount is inflated because it does not reflect those items coded a "3" that were partially found. That is, of the 129 line items coded a "3" as not found, 25 line items represented items that were partially found. Therefore, it is appropriate to exclude those records partially found in the percentage calculation of any overstated records. As a result, the 10.5 percent of record items coded a "3" needs to be adjusted downward to 8.5 percent.

More fundamentally to the matter of alleged results of the physical verification audit, displaying results as a percentage of line items is misleading and a mischaracterization. It is misleading because it does not properly weight line items. That is, a \$50 dollar item is given the same weight as a \$50 thousand dollar item. Ameritech submits that displaying and referring to results as a percent of investment and incorporating Ameritech's and AA's corrections to the December Report's scoring shows that on an investment basis, the not found items (including those items partially not found) reflect about 4 percent of the total investment, which given the constrained time frame to conduct the reperformance verification, is not unreasonable (See Affidavit of Carl R. Geppert, Appendix A-0). While a further reduction of the 4 percent amount is possible, Ameritech maintains that there are no ratepayer or shareholder benefits in accomplishing this objective. Notably, this 4 percent amount is remarkably close to the 3 percent amount found in the 1994 audit, where the preliminary conclusion was that nothing led the auditors to conclude that Ameritech was not in compliance with the Commission's CPR rules.

The summary and table of verification results on Page 9 of the December Report needs to be revised to incorporate the above comments. At a minimum, categories should follow the four scoring types and descriptions used by the Accounting Safeguards Division in its physical inventory and any alleged overstatement should be based on investment rather than line items. Also, the results should reflect the revised scoring as discussed following.

4. Scoring Results of Arthur Andersen LLP

Ameritech retained Arthur Andersen LLP (AA) to review the scoring on the July Report of many items scored "3", to evaluate supporting documentation and, to perform physical inventories as required. While the results were apparently not considered to any meaningful extent in the December Report, in a period of two weeks, Arthur Andersen LLP was able to substantiate many of the items coded "3" by the

Accounting Safeguards Division either through physical verification or the review of supplemental information. AA also adjusted the sample by removing portable and other items retired prior to the November, 1997 on-site physical verification conducted by the Accounting Safeguards Division but in service prior to July 31, 1997 (See Affidavit of Carl R. Geppert at Appendix A-0 at 5; See Arthur Andersen Report Appendix A-4, Carl R. Geppert Affidavit). Ameritech submits that AA was operating under a time constraint in its review and that an explanation is available for each sampled item. Despite this time constraint, AA's and Ameritech's review and substantiation resulted in a significant reduction of investment coded "3" (See Affidavit of Carl R. Geppert at Appendix A-0 at 5; See Arthur Andersen Report Appendix A-4, Carl R. Geppert Affidavit, Attachments 1,2, and 3 for a detailed explanation of AA's revised scoring results). This reclassification by AA itself casts serious doubt over the results provided by the Accounting Safeguards Division in the December Report.

5. The Statistical Methodology

AA's review of the sampling methodology used by the Accounting Safeguards Division shows numerous flaws which were not corrected in the December Report: (i) the unlikelihood that the audit sample represents the true population since offices with less than 100 records are excluded from the population, (ii) lack of correcting for use of a cluster rather than stratified sampling methodology, (iii) an inaccurate variance calculation, given that the Accounting Safeguards Division has chosen a cluster sample, (iv) the introduction of additional bias with the lack of incorporating underreporting in the audit plan and, (v) with AA's re-verification results, the accuracy of the sample results in an unknown degree of error. (See Affidavit of Carl R. Geppert at Appendix A-0 at 5-7; See Arthur Andersen Report Appendix A-5, Affidavit of Paul Charnetzki).

Given the significant flaws in the procedures used by the Accounting Safeguards Division and the deficiencies in the sampling methodology, the audit results are not reliable. Based on the revised scoring determined by AA and including Ameritech's revisions related to inconsistent scoring prior to the release of the December Report, the extrapolation of items not found to date equates to \$182.6 million \pm \$88.9 million (See Affidavit of Carl R. Geppert at Appendix A-0 at 5; See Arthur Andersen Report Appendix A-1, at 4; Appendix A-4, Carl R Geppert Affidavit at 6; Appendix A-5, Paul Charnetzki Affidavit at 3 and Attachment 2). Furthermore, from a statistical standpoint, there is no basis to extrapolate beyond the lower bound of the point estimate of \$93.7 million (See Ibid.). Ameritech maintains however, extrapolated results should not be represented as plant overstatement given the flawed audit procedures (See also Affidavit of Carl R. Geppert at Appendix A-0; See Arthur Andersen Report, Appendix A-1; Appendix A-5, Affidavit of Paul Charnetzki).

The results above are included solely to demonstrate that in a limited amount of time, Ameritech was able to reduce the alleged overstatement of plant investment by 50 percent, which, in and of itself, demonstrates the fatal flaws in both the audit procedures and results.

6. Undetailed Investment

The December Report asserts that the Accounting Safeguards Division found more than 4,000 line items with no CPR equipment or location description representing \$260.7 million dollars of Undetailed Investment (See December Report at 4, 28-30). This \$260.7 million dollars of Undetailed Investment was added to the \$306.0 million hardwire investment to form the basis of the alleged plant overstatement of \$566.7 million. According to the December Report at 29, Ameritech failed to substantiate the physical existence of the equipment or provide cost support. It is further asserted that follow up verification procedures are necessary to adjust the Undetailed Investment to reflect Ameritech's claim after the on-site fieldwork that the balance was reduced to \$252.8 million as of August 31, 1998 and that \$114 million of the \$252.8 million associated with plant purchased from Sprint would be detailed by end of year 1998 (December Report at footnote 38).

Ameritech strongly objects to the inclusion of Undetailed Investment in the December Report. At a minimum, the investment balance should be reduced to \$138.8 million (See Appendix G; Ameritech plans to provide under separate transmittal the necessary documentation for the \$114 million Sprint investment). This investment represents used and useful investment in the provision of telecommunications service and will be retired when appropriate.

Undetailed Investment is neither a term nor an investment category unique to Ameritech. Rather, it is an investment category that has been in use for thirty years and which predated the conversion to the mechanized Plug-In Inventory Control System/Detailed Continuing Property Record (PICS/DCPR) under the AT&T Bell System. Ameritech has been retiring Undetailed Investment when appropriate and will continue to do so.

With respect to the genesis of Undetailed Investment, the Undetailed Investment category definition and record-keeping practices were initially communicated to the Commission by AT&T in 1968 when the plans for the new mechanized PICS/DCPR system were being developed. Undetailed Investment was to include the embedded hardwired equipment and to be recorded as "Undetailed Investment" in the PICS/DCPR system, with a CPR record number of 040000. That is, the Undetailed Investment was not to be detailed. Rather, only new hardwired equipment would be detailed in the PICS/DCPR system. The office location, i.e. address, provided the information on the location and the equipment description would be included in the FRC (Field Reporting Code, which translates to an account) field and in the ECN (Equipment Category Number) field on the CPR. The ECN field contains numeric/alpha information which can be translated to various categories of equipment, e.g., distributing frame, 1AESS equipment or power (See Appendix E, Letter of Mr. A. L. Scott, Vice President and Comptroller, AT&T, to Mr. Ben F. Waple, Secretary, Federal Communications Commission of September 11, 1968; See also, Appendix F, American Telephone & Telegraph Company Outline of Plan for a Mechanized Detailed Property Record of Central Office Equipment, File No. M-295, May 22, 1968 at Section 1.07, "Undetailed investment is reflected in the record by location, account, and year of placing", "the M-295 Letter"; See also, the M-295 Letter at Attachment 1, Page 1, where "location" is shown to be office location, i.e. address, and description is shown to be "Undetailed Investment").

The operating companies in the Ameritech region, pre-divestiture from AT&T, converted to the mechanized PICS/DCPR system in the following years: Michigan, 1975; Ohio, 1978; Wisconsin, 1978; Indiana, 1978; Illinois, 1982. Prior to conversion, the manual central office equipment records and balances were continuously updated and verified within the depreciation, accounting, and engineering organizations. At the time of conversion, the operating companies of Ameritech implemented the mechanized PICS/DCPR system as initially outlined by AT&T in the M-295 Letter. This implementation included the determination not to detail the embedded hardwired equipment as a cost benefit consideration because it was too expensive. Such implementation included the adoption of "location" to be office location, i.e. address, and description on the CPR as "Undetailed Investment." The BPR for Undetailed Investment consisted of supplemental information, i.e. estimate authorizations, CO engineering work orders, together with the information contained on the CPR.

At the time of conversion to the mechanized PICS/DCPR, Undetailed Investment was approximately 70 percent of the COE investment. At the time of the 1994 audit of Ameritech by the Accounting Safeguards Division, Undetailed Investment had declined from \$555 million as of December 31, 1993 to \$414 million as of December 31, 1994. As of July 1997, Undetailed Investment was approximately \$260.7 million. Of the \$260.7 million, \$109 million was due to the pending purchase from the Sprint Corporation. In order for Ameritech to assume operational control by the November 1, 1997 closing date, it was necessary to pre-load Ameritech's operations support and provisioning systems, including PICS/DCPR, in advance of the purchase. No investment however, or related depreciation regarding the purchase was recorded in Ameritech's financial records until the closing date of November 1, 1997. When the August 1998 Undetailed Investment is adjusted for the purchase, the actual remaining Undetailed Investment is

approximately \$138.8 million, or 1 percent of the COE investment (See Appendix G). This is a 75 percent reduction in Undetailed Investment since 1993. This reduction in Undetailed Investment since the inception of the PICS/DCPR system shows that as the Undetailed Investment is taken out of service, it has been retired.

Much of the Undetailed Investment is associated with analog equipment. As the analog equipment is removed and retired from service, so too is the Undetailed Investment (See Ameritech 1994 Audit Response, Letter of Ms. Robin Gleason to Mr. Rudolph Bruno, December 12, 1994 at Page 2). As of August 1, 1998, Ameritech has 54 locations that still have switches. Undetailed Investment of \$97.6 million associated with these locations is legitimate, used and useful investment, and will be retired at the appropriate time.

With respect to the physical existence of Undetailed Investment, an engineer with expert knowledge on investment categorized as Undetailed Investment, physically verified the existence and functionality of the equipment recorded as Undetailed Investment at an Ameritech - Illinois analog central office (See Appendix D, Affidavit of Maggiefeld). Additionally, and as transmitted under a separate confidential cover, Ameritech filed that same office's floor plan, wiring lists and the original invoices which purchased the analog, Undetailed Investment. The floor plan and wiring lists were marked with respect to where in the building the engineer located the Undetailed Investment and what Undetailed Investment equipment was located. The original invoices did not exactly match that current office's Undetailed Investment records due to activity that has occurred since the installation e.g., partial retirements and reclassifications. However, with this corroborating evidence it is inappropriate to suggest that this investment does not exist given the historical record on its origination with the implementation of the PICS/DCPR system and systematic retirement since that implementation. Additionally, the triennial depreciation represcription process routinely reviewed plant balances and vintage data, mortality studies, and actual and projected retirement information. We are not aware of any significant issue surrounding Undetailed Investment that surfaced during the represcription process conducted by the Commission. It is unclear why this is suddenly an issue for the Commission in a price cap environment.

With respect to the cost support, Ameritech has maintained throughout this audit and the audit in 1994, that supporting documentation, together with the information listed on the CPR, comprise the BPR. Ameritech is unable to provide the information for the sampled 25 items at this time because of the age of the equipment and the sampled equipment is not at any of the 54 analog locations. The Accounting Safeguards Division should however, weigh the benefit of continuing to investigate and request original cost documentation for this category of investment given the dramatic decrease in the level of investment since the late 1970s and the plans for its systematic retirement.

The December Report asserts at 12 that Ameritech had committed to retire all Undetailed Investment by end of year, 1999. Since Undetailed Investment is predominately associated with analog switching equipment, Ameritech had planned and expected that all Undetailed Investment would indeed be retired by end of year, 1999 due to the replacement of analog switches. Since 1994, and as communicated to the Accounting Safeguards Division on February 19, 1998, the business case for the replacement of analog switches changed to delay the appropriate retirement of this investment. As a result, analog switches will remain in service after 1999. The December Report's characterization, or lack of explanation, as to why Ameritech continues to have minimal amounts of Undetailed Investment is misleading.

As a result, Ameritech objects to the inclusion of all references and findings related to Undetailed Investment in the December Report. Ameritech is willing to discuss its plans related to the retirement of this investment separate from the December Report. Alternatively, the facts pertaining to Undetailed Investment should be incorporated into the December Report to facilitate the appropriate perspective and proper assessment.

7. Unallocated Investment

The December Report asserts that the Accounting Safeguards Division found more than 7,000 line items with no CPR equipment or location description representing \$64.6 million dollars of investment which Ameritech refers to as Unallocated Other Costs (See Draft Report at 2 and 31). The December Report further asserts that the Accounting Safeguards Division does not have sufficient documentation to determine the nature of these costs, but intends to issue a further report (See December Report at 31).

Ameritech submits that, like Undetailed Investment, Unallocated Other Costs, is an investment category that has been in use for over thirty years (See M-295 Letter at Section 2.42). With respect to the substantiation of physical plant, Ameritech provided the definition of Unallocated Other Costs which showed that, by definition, this category of investment does not represent physical units of equipment and therefore is not physically verifiable (See Ameritech letter of Mr. James Deignan of November 2, 1994 to Mr. Richard Gaarn; See also Ameritech presentation materials of February 19, 1998 to Accounting Safeguards Division). The ambiguity with respect to the substantiation of Unallocated Other Costs by physical examination is misleading.

Since the December Report states that a determination on Unallocated Investment is forthcoming and since no conclusions on Unallocated Other Costs are included in the December Report, Ameritech objects to the inclusion of all references and allegations related to this investment in the December Report.

8. Other Errors and Omissions

Other errors and omissions contained in the December Report are detailed on Appendix C. These errors and omissions mislead the reader through mischaracterization and irrelevant topics.

With respect to mischaracterization, there are a number of statements made in the report which do not reflect the facts (see Appendix C, Errors and Omissions Nos. 2, 3, 4, 8, 9). Notably missing from the December Report are instances where the auditors from the Accounting Safeguards Division were shown more equipment than the CPR records indicated (See also, Affidavit of Carl R. Geppert at Appendix A-0 at 6; Arthur Andersen Report Appendix A-4, Affidavit of Carl R. Geppert). Inaccurate conclusions may be drawn from this omission.

Ameritech disagrees with the inclusion in the December Report of topics that are mischaracterizations such as the Section entitled "Duration and extent of Problem" (December Report at 32-33). The December Report attempts to make Ameritech's alleged CPR problems "longstanding" that were first identified during the 1994 audit (See December Report at 32-35). The preliminary conclusion of the 1994 audit however was that, " nothing came to our attention during the audit that would lead us to conclude that Ameritech was not in compliance with the FCC Rules Section 32.2000 Instructions for Telecommunications Plant Accounts." (emphasis added) (See letter of Mr. Rudolph Bruno, Chief, Accounting Safeguards Division New York Field Office to Mr. Anthony Alessi of Ameritech, November 9, 1994 at 5). The results of the 1994 audit, as the Commission itself concluded in 1994, were hardly an indication of a "longstanding" problem. Also, the December Report provides no basis whatsoever for the conjectural assertion of a likely error rate of 20 percent a year for new line items (See Draft Report at 32). Ameritech strongly objects to the inclusion of this entire section in the December Report and it should not be relied on by the Commission with respect to any future contemplated action (See Appendix C, No. 15).

Another anomaly is how the December Report characterizes those items scored a 4, unverifiable during the audit. It is asserted that 23.3% of the records were seriously deficient and did not comply with the Commission's rules (See December Report at 1). Included in the 23.3% are items that were scored a 4 (2.8% of the 23.3%). Ameritech disagrees that items the auditors of the Accounting Safeguards Division scored a 4 are seriously deficient and not in compliance with the Commission's rules. Rather, many of

these items could not be verified with certainty at the time of the on-site audit due to the time constraint of the physical verification, the complexity associated with the equipment descriptions, and deployment configurations in the central offices. For example, many items that were scored a "4" were scored as such because of a zero quantity on the record. As contained in the support documentation provided to the Accounting Safeguards Division, zero is a legitimate record count (See Appendix B). Therefore, Ameritech disagrees that items scored a "4" are seriously deficient.

As a result of the errors and omissions identified on Appendix C and other deficiencies identified in other sections of these comments, if released, Ameritech objects to the inclusion of errors and omissions related to mischaracterizations, i.e. duration and extent of problem with misstatements related to the 1994 audit, and irrelevant topics, i.e. inclusion of Undetailed Investment and Unallocated Costs.

B. The CPR has No Ratemaking Impact

The December Report asserts that the deficiencies in Ameritech's CPR records raise questions about Ameritech's plant accounts (See December Report at 36). Ameritech disagrees and submits that in a price cap environment, the CPR has no impact on the application of the Commission's rules relating to depreciation rates (C.F.R. Section 43), jurisdictional separations (C.F.R. Section 36), cost allocations (C.F.R. Section 64), or rates charged to customers (C.F.R. Section 61; Section 65).

The current CPR requirements were adopted under a cost of service/rate of return regulatory paradigm. The FCC transitioned from cost of service/rate of return regulation to price cap regulation in 1991. Under price caps, rates are determined based on a price cap index which is adjusted annually for inflation, productivity, and any exogenous adjustments. Ameritech has had 'pure' price cap regulation since 1995 (i.e., no sharing). This new regulatory paradigm requires the Commission to review and streamline these outdated requirements.

Ameritech has evaluated various aspects of the CPR requirements with respect to their impact on the application of the Commission's depreciation, separations, cost allocations, and financial statements and customer rates, and demonstrates below that there is no adverse impact on customers. Certain of the items discussed below such as separations and depreciation clearly do not impact rates in a no-sharing price cap regulatory paradigm where costs are neither directly nor indirectly tied to rates. Furthermore, as demonstrated in the discussion below, the concerns of the Accounting Safeguards Division are unwarranted with respect to when there were price caps with sharing provisions or when price caps were first initialized. Even in these situations, ratepayers were not adversely affected.

Any CPR discrepancies are most likely immaterial record-keeping matters and may at most reflect delayed retirements. Ameritech has evaluated the impact of any delayed retirements on various financial and customer issues.

Ultimately, to support the conclusions that ratepayers were adversely impacted, the audit would need to establish that, prior to 1991, the CPR reflected instances of actual overstatement of COE investment related to a fraudulent creation of CPRs. There is simply no basis for an audit finding indicating that such activity occurred.

1. There is No Ratebase Impact

Any delay in the recording of an asset's retirement has no bearing on the rate base component of financial results because net investment (original cost of assets less accumulated depreciation) constitutes the rate base. Under the composite group method of depreciation accounting, non-extraordinary retirements reduce the asset balance and the accumulated depreciation reserve by the same amount. Therefore, the book retirement of an asset has no effect on the net investment, or rate base.

For example, assume an asset base of \$500 M and a reserve level of \$300 M. The resulting rate base is \$200 M (\$500 M - \$300 M). If a \$100 M retirement occurs, the asset base is \$400 (\$500 M - \$100 M) and the reserve is \$200 M (\$300 M - \$100M). The resulting rate base REMAINS \$200 M (\$400 M - \$200).

2. There is No Depreciation Expense Impact

Depreciation expense is calculated as follows:

Plant Base x Depreciation Rate = Depreciation Expense.

Remaining life depreciation was authorized by the Commission in 1981 and is designed to recover net plant over its average remaining life. With remaining life depreciation, there is no overstatement of depreciation expense as a result of any delayed retirements. Both the plant base and depreciation rate components of the depreciation expense calculation are impacted by plant retirements as the example below demonstrates.

Simplistically, remaining life depreciation is calculated as follows:

$$\frac{\text{How much do you have left to recover}}{\text{How long do you have to recover it}} \quad \text{Or} \quad \frac{100\% - \text{Reserve \%}}{\text{Remaining life}}$$

Using the above example, assume a \$500 M asset base and a \$300 M reserve (a reserve percent of \$300/\$500 or 60%) and a four year remaining life. The remaining life depreciation rate is:

$$\frac{100\% - 60\%}{4} = 10\% \text{ rate}$$

The corresponding depreciation expense would be calculated as:

$$\$500 \text{ M} \times 10\% = \$50 \text{ M}$$

For comparison purposes, assume a \$100 M retirement. The asset base is \$400 M and the reserve is \$200 M (the reserve percent is \$200/\$400 or 50%). The remaining life rate is:

$$\frac{100\% - 50\%}{4} = 12.5\% \text{ rate}$$

The corresponding depreciation expense would be calculated as:

$$\$400 \text{ M} \times 12.5\% = \$50 \text{ M}$$

In this simplified example, the resulting depreciation expense is the same BEFORE and AFTER the retirement. In the real world, depreciation rates may not be set each year so there may be temporary under or overstatements of depreciation expense, but this situation will self-correct with remaining life depreciation.

For example, assume the \$100 million retirement occurred, but the 10 percent depreciation rate was not changed for 2 years. The depreciation rate would be understated these two years (10% vs. 12.5%) but then would catch-up the shortfall in years 3 and 4 (15% vs. 12.5%) as the following table demonstrates:

	Investment	Depreciation Rate	Depreciation Expense	Depreciation Reserve	Depreciation Reserve %
Year 1	\$400	10%	40	\$240	60%
Year 2	\$400	10%	40	\$280	70%
Year 3	\$400	15%*	60	\$340	85%
Year 4	\$400	15%	60	\$400	100%

* Recalculated depreciation rate: $\frac{100\% - 70\%}{2 \text{ year remaining life}} = 15\%$
at the end of year two

Additionally, if retirements had increased, a shorter remaining life would likely have been prescribed by the Commission resulting in a higher depreciation rate because the Commission depreciation represcription process relies on retirement analysis, i.e. the higher the retirement levels, the shorter the prescribed lives.

Continuing with the example, assume the \$100 M retirement provided evidence that the actual remaining life was three years, not four. The resulting depreciation rate and expense would be as follows:

$$\frac{100\% - 50\%}{3} = 16.7\% \text{ rate}$$

The corresponding depreciation expense would be:

\$400 M x 16.7% = \$66.8 M, an increase in depreciation from \$50 M with no remaining life change

Lastly, in 1994 Ameritech recorded a \$2.25 billion non-cash charge and increased its depreciation reserve on its financial books to reflect the lower value of its assets in a competitive market. Ameritech is currently using economic lives for financial reporting purposes that are much shorter than Commission prescribed lives. Ameritech does not believe that the Commission's range of depreciation lives in any way reflects the technology and competitive situation Ameritech confronts. Ameritech strongly disagrees with any suggestion or statement that Ameritech is overdepreciated on its regulated books.

In conclusion, depreciation expense (and consequently revenue requirements) would not be overstated as a result of any purported plant overstatement.

3. There is No Price Cap Impact Adverse to Customers

3a. Calculating Low Formula Adjustment Mechanism (LFAM)

The Commission's price cap rules currently include an automatic earnings adjustment if a carrier's rate of return falls below 10.25%. Low-end earnings adjustments are determined from reported rate of return results. Since the rate base component of a rate of return analysis is based on net investment, temporary unrecorded retirements have no impact on the rate base component of the low-end earnings adjustment calculation.

Also, as indicated above, depreciation expense has not been overstated (and the earnings have not been understated) as a result of any delayed retirements. Therefore, there is no impact on rate of return and consequently, the low-end earnings adjustment.

As a point of fact, Ameritech has not triggered the low-end adjustment since the inception of price caps in 1991.

3b. Determining Productivity Factors for Price Cap Companies

Annual interstate price cap filings are required for companies such as Ameritech that are regulated by the Commission's price cap plan. These filings annually adjust the maximum interstate revenues by inflation less a productivity factor. Thus, the higher the productivity factor, the lower the price cap ceiling (and rates).

The Commission's current productivity factor is 6.5%. The Commission based this factor on three components: a Total Factor Productivity (TFP) differential (3.2%), an input price differential (2.8%), and a Consumer Productivity Dividend (0.5%). Any alleged overstatement of plant investment would impact the TFP differential, since it relies on gross plant investment as an input. However, as demonstrated below, any alleged plant overstatement would have resulted in a higher TFP (and higher productivity factor) and thus lower access rates.

The measure of TFP is the difference between the growth in output, (e.g. calls, lines, MOU, etc.) and the growth in input (labor, capital and materials). Only the input related to capital would be affected by an overstatement of gross plant.

As part of the Commission proceeding on establishing the productivity factor, Christensen Associates developed and presented a TFP study on behalf of USTA (See In the Matter of Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, released January 16, 1996). The United States Telephone Association's (USTA) Total Factor Productivity Review Plan (TFPRP) estimated the industry productivity factor. The TFPRP used the 1988 total gross plant in computing the base for the first year and for the following years used capital additions using the perpetual inventory model.

If the alleged overstated plant had been removed from the USTA study, it would reduce the gross plant in the base year and therefore, would have increased the growth in capital input (and therefore the total growth in input, all other factors being constant). Assuming the growth in output would remain constant and a larger growth in input would have been subtracted, this would have resulted in a lower TFP productivity factor. A lower productivity factor would have resulted in higher access rates.

Thus ratepayers have not been harmed from any alleged plant overstatement.

4. There is No Adverse Impact on Cost Studies for Interconnection

Continuing property records have no adverse impact on Ameritech's interconnection price development or any other LEC charges. Ameritech determines its Long Run Service Incremental Costs (LRSICs), Total Element Long Run Incremental Costs (TELRICs) and Forward-Looking Economic Costs (FLECs) based on long run economic principles. The LRSIC determines costs in support of retail services, while the TELRIC determines costs in support of unbundled network elements. The FLECS are used to determine costs for services in support of the universal service fund. All of these studies are developed based on forward-looking long-run economic cost principles.

The calculation of LRSIC, TELRIC or FLEC begins by identifying the resources required to satisfy demand for a service. These resources may consist of material, software, and labor. The costs of these resources are treated either as assets to be capitalized for future recovery, as non-recurring expenses, or as recurring expenses. The resources included in these studies reflect only incremental, forward-looking, state-of-the-art technology and exclude costs that cannot be directly attributed to a particular service or subclass of that service. Costs that are not incremental (i.e., those costs that would not disappear with the elimination of the service) are excluded from the studies.

An example of a resource cost that would be capitalized is an outside plant cable, which is employed to provide the network access line between a customer's location and an Ameritech central office. This treatment is appropriate because the Company will use the outside plant cable and equipment items to provide local loops to many customers over a long period. The investment for the loops is developed

from a cost model that determines the economic cost of providing a loop using forward-looking designs and technology. Accounting balances are not used to derive this investment. Such capital investments are converted to annual charges, which recover the investment (i.e., depreciation) and the cost of capital and taxes associated with that investment.

Conversely, the labor cost of processing a service order is an example of a one-time, non-recurring expense. This treatment is applied because the service order cost is incurred for and recovered from a single customer at a single point in time. This cost, like the investment discussion above, is not derived from accounting balances.

Other ongoing costs such as maintenance costs are expected to be incurred each year the service is offered. These costs are treated as current expenses in each year they are incurred. Ameritech develops cost factors that are applied to the forward-looking unit investment to incorporate these costs into its LRSICs, TELRICs or FLECs.

Ameritech has reviewed its cost procedures and methodologies and has found only two instances where cost factors rely on investment balances from accounting records - maintenance factors and ad valorem tax factors. In both cases, factors are developed based on the relationship of recorded expense to recorded investment. To the extent that the investment (i.e., the denominator) is "overstated", the result has been to realize a smaller cost factor and consequently lower annual costs.

For example, assume the recorded maintenance expense for digital electronic switching is \$200 million and the investment is \$3.5 billion:

The maintenance factor is:

$$\frac{\$200 \text{ million}}{\$3,500 \text{ million}} = 0.05714$$

Assume the plant balance was overstated by \$200 million. The maintenance factor, adjusted downward to reflect a \$200 million overstatement, would be recalculated as:

$$\frac{\$200 \text{ million}}{\$3,300 \text{ million}} = 0.0606$$

Maintenance factors are applied to forward-looking investment amounts in the cost studies. As the example demonstrates, any overstatement of investment would have resulted in a lower maintenance factor and lower costs. Therefore, if anything, Ameritech's cost studies may have understated maintenance costs. Once again, there would be no adverse impact on any customer rates.

With respect to resale discounts, the December Report's findings do not impact resale discount calculations. Section 252(d)(3) of the Telecommunications Act of 1996 provides that wholesale rates shall be determined "on the basis of retail rates charged to subscribers for the telecommunications service requested, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier." There have been numerous approaches that have been used to develop the avoided costs associated with providing telecommunications services at resale versus retail. All of these approaches (ARMIS based as well as others) universally recognize that underlying network investment is not utilized in the resale discount calculations. Rather, the focus is on identification of avoided expense (USOA expense accounts, 6XXX). Network related expenses are specifically excluded from the development of avoided cost (See C.F.R. Section 51.609(c)(3)).

Once again, there would be no adverse impact on any customer rates.

5. There is No Separations or Cost Allocations Impact

5a. Impact on Jurisdictional Separations

The separations process assigns gross booked investment to the inter and intrastate jurisdictions based on relative usage factors developed in accordance with the Commission's Part 36 rules. The associated expenses follow the allocations of that investment. In the past, separations data has been used to calculate inter or intrastate revenue requirements. The resulting revenue requirement however, is calculated based on net book cost. As indicated above, net plant (and consequently the ratebase) does not change as a result of unrecorded retirements. As a result, any temporary unrecorded retirements do not cause any significant shifts in jurisdictional results.

5b. Impact on Cost Allocations

The Commission's Cost Allocation Rules (C.F.R. Section 64.901, Allocation of Costs), specify a hierarchical methodology of assigning costs between regulated services and non-regulated activities based on maximizing direct assignment. Costs that cannot be directly assigned are grouped into homogeneous cost pools and allocated on the basis of a cost causative linkage to other more directly assignable costs. There is no significant change to the cost allocation results from any delayed retirement of investment because of the marginal impact investment, as a cost causative linkage, has on the allocations to non-regulated. Specifically, central office non-regulated plant in-service is only 1.62 percent of total plant in service and very few expense cost pools are allocated using the relative investment value of central office assets. Of the 173 cost pools used to apportion expenses in Ameritech's Cost Allocation Manual, only 10 use the relative investment value of central office assets. As a result, any temporary unrecorded retirements do not cause any significant cost allocation shifts.

In summary, there would have been no negative impact to ratepayers as a result of any purported plant overstatement.

C. Audit Recommendations

The December Report recommends that Ameritech (i) write-off \$306.0 million of hardwired COE investment plus an additional write-off of \$260.7 million of Undetailed Investment, (ii) engage an independent firm to inventory its entire COE and provide the results to the Commission, (iii) make necessary accounting entries as a result of the inventory, (iv) engage an independent auditor to review its CPR practices, procedures, and controls and make recommendations for improvements and, (v) develop and submit to the Commission for approval a plan of corrective action (See December Report at 40-43).

Ameritech cannot agree to a write-off of \$306.0 million of COE hardwired investment given the identified deficiencies in the audit procedures and statistical methodology that renders the results unreliable. Moreover, a write-off of \$306.0 million is contrary to the Commission's rules requiring a retirement entry to be referenced to the CPR from which the cost was obtained (See C.F.R. 32.2000(d)(1)). In other words, a write-off makes no practical accounting sense in that the particular plant and location for which the plant is to be written off are not identified since the alleged overstatement is based on an extrapolation. Since the alleged overstatement is an extrapolated amount, there is no such reference to the CPR. (See also, Affidavit of Carl R. Geppert at Appendix A-0 at 7-8). Ameritech cannot agree to a write-off of \$260.7 million of Undetailed Investment because \$109 million represents COE purchased from Sprint that was detailed by end of year, 1998 and the balance represents used and useful telecommunications equipment. Even if the proposed recommendation to write-off this investment were valid, there has been absolutely no adverse impact on Ameritech's customers that would justify any reduction of Ameritech's current rates.

Ameritech also cannot agree to engage an independent firm to inventory its entire COE. Such an undertaking is not justified on a cost benefit basis. It is estimated that an inventory of its entire COE could take over five years at 700,000 hours and cost over \$35 million. This expenditure would be wasted because neither ratepayers nor shareholders would receive any benefit. Apart from any cost benefit considerations, such an undertaking is unwarranted and, at best, premature before any evaluation of Ameritech's CPR practices, procedures, and controls was completed.

While Ameritech cannot agree with the December Report's recommendations on investment write-offs or an inventory of its entire COE, since Ameritech is fully confident that its practices, procedures, and controls for maintaining CPR are compliant with the Commission's rules in all material respects, Ameritech is willing to discuss the engagement of an independent auditor to review such practices, procedures, and controls and make recommendations for improvements, if necessary. Ameritech would further agree to develop and submit to the Commission for approval a plan of corrective action based on any agreed upon independent review, if such corrective action is found to be necessary.

Ameritech submits that a fair assessment of Ameritech's CPR would suggest that there is no reasonable basis for finding any overstatement of COE plant investment. This is supported by the results of the Arthur Andersen LLP review. Ameritech does not concede any overstatement, since the audit processes are flawed in a number of areas and no direct evidence of fraudulent record creation has been established. Put another way, even if the Accounting Safeguards Division CPR audit suggests a failure to strictly comply with record-keeping requirements resulting in an apparent overstatement, it provides scant evidence on which to base a conclusion that COE plant investment is in fact overstated. Such a conclusion is especially speculative when more logical explanations exist, e.g. the equipment is in fact still in place, but not "readily" found or that the "missing" COE was the subject of a delayed retirement.

III. Conclusion

For the foregoing reasons, contrary to the conclusions and recommendations in the December Report on Ameritech's Continuing Property Records (CPR), Ameritech's CPR is not deficient in any material respect with the Commission's CPR rules. An analysis and review of the December Report conducted by Arthur Andersen LLP and Ameritech shows that the findings contained in the December Report are fatally deficient with respect to audit procedures pursuant to generally accepted auditing standards (GAAS), statistical methodology, and the scoring of audited results. As a result, Accounting Safeguards Division recommendations on investment write-offs and inventories of Ameritech's entire Central Office Equipment (COE) investment have no basis. However, as Ameritech is fully confident that its CPR practices, procedures, and controls are compliant in all material respects with the Commission's rules, Ameritech is willing to discuss the engagement of an independent auditor to review such practices, procedures, and controls.

For the foregoing reasons, Ameritech further submits that there has been absolutely no adverse impact on Ameritech's customers that would justify any reduction of Ameritech's current rates. As a result, the December Report should not be relied on by the Commission with respect to any future contemplated action.